

Estate Planning for Farm Families

AT A GLANCE:

Federal Estate Taxes

- From 2013 and on, the federal estate tax exemption is \$5.25 million and will be adjusted each year for inflation. The federal estate tax exemption is the amount that you can pass to your heirs' estate tax-free upon your death.
- In 2013, the exemption is set at \$5.25 million.
- The federal estate tax rate is 40% for estates over the \$5.25 million exemption.
- Portability is also now a permanent feature of federal estate tax law. Portability allows a spouse to use the unused portions of a predeceasing spouse's federal estate tax exemption.

Glance continued on page 2



PHOTOS: EDWIN REMSBERG



Many children see farming as their life's occupation. Setting goals and preparing a transition plan facilitate them taking over the farm. Families without estate plans may have large tax liabilities and those without wills allow the state to determine who receives the property.

All people who own real or personal property should engage in estate planning. While few of us like to think about our eventual death, planning can ensure that we decide who receives our belongings rather than the state or probate court deciding. Estate planning is particularly essential for farmers who have had their farm real estate value increase over time. Without planning, some families may be forced to sell land that they wish to retain in order to pay estate taxes or to buy out

heirs that do not wish to stay on the farm. Strategies to reduce estate taxes and buying out off-farm heirs require planning to be effective.

This fact sheet presents some of the basic tools farm families can use to reduce estate tax burdens and pass on the farm to heirs. First, families need to set goals for their individual needs and desires and determine their net worth. (See Maryland Fact Sheet 414: Estate Planning: Goals, Net Worth and Final Instructions.) Once this is done,



PHOTO: EDWIN REMSBERG

For more information on calculating net worth, see University of Maryland Extension Fact Sheet Number 540 and Fact Sheet Number 414.

The majority of farmers have wealth tied up in the land and equipment needed to run the farming operation. Farmers who do not take the necessary steps to develop estate plans could see operations built up over their lifetimes sold to satisfy estate taxes. Proper estate planning can help farmers limit situations where farming operations have to be sold to pay the estate taxes.

Glance continued from page 1

Maryland Agricultural Estate Tax Exemptions

- In 2012, the state legislature created a special estate tax exemption for agricultural property.
- Maryland will now allow the first \$5 million of agricultural property (both personal and real property) to be exempt from state estate taxes. Amounts in excess of \$5 million will be taxed at 5% instead of the 16% for nonagricultural property.
- To qualify, someone would have to agree to continue using the property for farming purposes for at least 10 more years.
- The state could recapture all the state estate taxes not paid under this exemption if the property ceases to be used for a farming purpose at any point within the 10 year period.

they can determine the best planning strategy to achieve their stated goals. Estate planning requires basic steps like preparing a will or changing the ownership structure of the farm. Trusts are another valuable planning technique. Some farm families may look at selling or donating an easement as an estate planning tool. Others may find transferring the farm before the death of the owner(s) works best for their situation and can do so either through a sale or through gifts. Another mechanism to overcome some of the problems of being land rich and cash poor is to invest in a life insurance policy. Also discussed are particular provisions applicable to farm families. These include the Special Use Valuation provisions and options for estate tax payments.

While this fact sheet presents some tools you can consider in your estate planning, each individual's and family's circumstances will be different. Therefore, you should seek the advice of a tax attorney, accountant, or financial advisor. The information in this fact sheet should prepare you to have a fruitful session with these advisors.

Determining Your Net Worth

Knowing what amount can be exempted from the estate before taxation is only useful if you know the fair market value of your gross estate. You need to sit down, list your assets and liabilities, and figure out your net worth. You may be surprised by how much your net worth actually is, especially if your land or business has not been appraised recently. Net Worth is Assets minus Liabilities. Assets include your land, buildings, livestock, equipment, personal residence, cars, other personal property, savings, stocks and bonds, pensions or other retirement savings. Assets can also include the value of any life insurance policies you own. Liabilities are any outstanding debts you owe on these items, such as mortgages, other loans, and policy premiums. For more information on calculating net worth, see University of Maryland Extension Fact Sheet Number 540 and Fact Sheet Number 414.

If your personal net worth in 2013 is near or above \$5,250,000 (or as a couple \$10,500,000), then you will want to do planning to minimize your estate taxes. Even if your estate falls below the exempted amount, estate planning can facilitate the transfer of your property and ensure the continuation of the family business. In addition, Maryland estate tax exempts only the first \$1,000,000 per person for non-agricultural property and the first \$5,000,000 per person for agricultural property, so planning



PHOTO: EDWIN REMSBERG

These strawberries were grown on a diversified three generation working family farm. Developing an estate tax plan will allow the parents to facilitate the transfer of the family farm to the five children involved in the operation.

may help avoid state estate tax even if you will owe no federal tax. Also, talking with your heirs now can avoid disagreements and disputes that can arise following your death. Stating your wishes now will help your heirs make decisions now and after you have gone.

Federal Estate Taxes

Federal estate taxes are levied on a deceased individual's taxable estate. The taxable estate is the gross estate minus allowable expenses and deductions. The gross estate refers to the assets owned by the deceased individual, plus the value of all underlying properties for retained life estates and any other assets under the deceased's control. An example of a gross estate for a farmer is shown in **Table 1**. While land and buildings are the largest asset amount valued at \$4.5 million, other assets on the farm, personal life insurance, and a bank balance add up to a total estate worth more than \$5 million.

Allowable expenses and deductions to the gross estate include funeral expenses, estate administrative expenses, gifts to spouse, debts owed by the deceased, Maryland estate and inheritance taxes, and charitable gifts. An example of these expenses and deductions are given in **Table 2**.

For this example, the total of these expenses and deductions is \$145,000. This amount is subtracted from the gross estate resulting in a taxable estate of

Table 1

Example of Farm Gross Estate	
ASSETS	AMOUNT (\$)
Land and Buildings	\$4,500,000
Machinery	\$240,000
Livestock	\$500,000
Crop Inventory	\$65,000
Feed and Supplies	\$20,000
Life Insurance	\$300,000
Bank Balance	\$75,000
Total	\$5,700,000

Table 2

Example of Allowable Expenses and Deductions for a Farm Estate	
Funeral Expenses	\$10,000
Legal Fees	\$15,000
Donation to Church	\$50,000
Bank Loan	\$60,000
Feed Store Account	\$10,000
Total	\$145,000

\$5.555 million. Federal estate taxes are calculated on this amount. The federal estate tax rate is now a flat rate at 40% for amounts above the exempted amounts in 2013 and forward. Unlike in previous years, the rates and exemption are permanent with no expiration date and will only change if Congress changes them. This lifetime exemption is pegged to inflation and will increase each year after 2013.

For the farm example with a taxable estate of \$5.555 million, only the amount above the \$5.25 million lifetime exemption is subject to tax payments in 2013. Therefore the taxable estate equals \$305,000. Given the 40% tax rate, the estate will owe \$122,000 ($305,000 \times 40\%$) within nine months of death.

Married couples should take into account the unlimited marital deduction that exists in federal estate taxes. Following the death of the first spouse, his or her half of the estate can be transferred to the surviving spouse tax-free, regardless of the value of the first spouse's estate.

Since 2011, the surviving spouse has been able to add the unused portion of the predeceased spouse's applicable exclusion amount to his or her own. This is known as portability and is now a permanent feature of federal estate and gift tax law. The applicable exclusion amount acquired from a deceased spouse (provided that the surviving spouse does not remarry) may be used to offset either the tax on lifetime gifts or transfers upon death. This is not automatic, however. The unused portion of the deceased spouse's federal estate tax exemption must be preserved for the surviving spouse to use. To preserve the unused portion, the deceased spouse's remaining applicable exclusion amount is taken on a timely filed (including extensions) estate

tax return (Form 706) upon which the remaining exclusion amount is calculated, and a statement is included on the face of the return that it is being taken by the surviving spouse. For example, Jim and Mary own a farm worth \$11 million. Jim dies in 2012 and his half of the farm (\$5.5 million) is passed to Mary through the unlimited spousal exemption. Mary files an estate tax return claiming the unused portion of Jim's exclusion amount (\$5.12 million). Mary passes away in 2013. Mary and Jim's kids would inherit \$10.37 million of the farm estate tax-free, because Jim had \$5.12 million of unused federal estate tax exclusions in 2012 that was portable to Mary. Mary also had a \$5.25 million federal estate tax exclusion in 2013. Jim and Mary's kids would owe federal estate taxes of \$252,000 or ($\$630,000 \times 40\%$) on the remaining \$630,000 of the estate.



PHOTO: EDWIN REMSBERG

Estate Planning Tools

When people think of estate planning, they typically think of having a will but their estate plan will be more than just a will. A will is only a document that directs how a person's property and assets should be distributed upon his or her death. The tools used in the estate planning process will reflect the individual's goals on not only distributing their property and assets, but contain plans for continuation of the family farm and placing the proper family members in charge of business and health decisions that could arise if the individual becomes incapacitated.

The common tools used in the estate planning process include:

1. Business entities, such as a limited liability company (LLC), partnership, or corporation
2. Gifts
3. Will
4. Titling of property
5. Trusts
6. Life insurance
7. Durable power of attorney, health care proxy, and living wills
8. Retirement planning

Each of these tools will be addressed within the coming sections. An estate plan will use some combination of these tools because each person will have different goals that need to be met in the process.

Durable powers of attorney, health care proxies, and living wills will not be addressed in this factsheet. These three

tools do not involve how to distribute a person's property but how to deal with health and business decisions if the person is no longer able to make those decisions. Durable powers of attorney and health care proxies appoint a representative or agent for a person in the event the person becomes incapacitated. A living will specifies the type of medical treatments the person would like to receive or not receive. Retirement planning will not be dealt with in this factsheet; however, it is important as a tool for ensuring that there is sufficient family income to finance intergenerational transfers.

For example, Bill runs a farming operation, his adult son Tom works for him, and Bill's wife has predeceased Bill. One day while working on the farm, Bill is severely injured and falls into a coma. If Bill has a durable power of attorney naming Tom as his agent, then Tom will be able to step into Bill's shoes in the farming operation and make decisions as if he is Bill. If Bill has named Tom as his health care proxy, then Tom would be able to step in and make those medical decisions necessary to keep his dad alive. Finally, with a living will Bill would be able to specify the medical care he would like to receive or not to receive. Bill may have decided to forgo the use of a ventilator or respirator in certain situations, for example.

Setting Goals

The first step of estate planning is setting goals for your business and for your personal life. These goals can include your property and income. Property includes both real property and personal property. Real property includes your land, house, farm structures, and all real estate improvements. Personal property includes cars, bank accounts, stocks and bonds, livestock, and farm equipment.

When people think of estate planning, they typically think of having a will but their estate plan will be more than just a will. A will is only a document that directs how a person's assets should be distributed upon his or her death. Estate plans reflect a person's goals and situations. For example, one family's estate plan might be to ensure young children or elderly parents are provided for, avoid conflict between on and off farm heirs, and minimize estate taxes.

You need to ask yourself, your spouse, and your children many questions to determine the best course of action.

Examples of goals that you may want to consider in estate planning include:

1. *Expandă* * the farm to enable your child to earn enough to support his or her family,
2. *Úrovidã* * retirement income for yourself and your spouse,
3. *Úl[çãã* * an income stream for dependents such as minor children or elderly parents,
4. *Öistributã* * your assets between your children and grandchildren,
5. *Önsurã* * that your children do not fight over the property, and
6. *Á inimizã* * estate taxes.

You need to ask yourself, your spouse, and your children many questions to determine the best course of action. For example, is there someone who wants to take over

the farm? Does the family want the property to stay in farming, or is selling to the highest bidder acceptable? Who will manage the farm if you become ill or disabled? Knowing what you hope to accomplish in the estate planning process facilitates choosing among the tools available.

Business Entity

According to the 2007 Census of Agriculture, around 83% of all farms in Maryland are sole proprietorships. A sole proprietorship is where one person owns all the assets and liabilities in a business and operates the business in his or her personal capacity. A sole proprietorship requires no legal documentation to be filed with the state to create and can be started at any time. The major problem with a sole proprietorship is that when the owner dies, the business ceases to exist. Sole proprietorships also create issues with transferring ownership interests from one generation to the next. Use of a business entity is one way to facilitate these transfers and can be used to achieve other goals.



PHOTO: BRUCE FITZ, USDA

Use of a business entity has traditionally been thought of as a way to limit an owner's personal liability in operating the business. As an estate planning tool, business entities allow for an easier way to transfer ownership interest in the farm from one generation to the next generation.

Common business entities utilized by agricultural operations are:

1. **Partnership** – an association of two or more individuals to jointly carry on a business. Each shares in the profits and losses of the partnership equally and each individual has the authority to bind other partners.
2. **Limited Partnership** – similar to a partnership, but allows for a separate partner who only provides capital and shares in profits or losses but does not participate in management decisions in the business.
3. **Corporation** – is an entity formed under state law to act as a single person, separate from the individuals owning the business, and has the right to exist indefinitely.
4. **Limited Liability Company (LLC)** – is an entity formed under state law containing elements of a partnership and a corporation.

Each of these entities may have some place in achieving goals in estate planning by allowing for efficient continuation of agricultural businesses from generation to generation. Multiple entities may be utilized depending on a person's goals. From our previous example, Bill runs a farming operation and owns multiple tracts of land. Bill has two children: Tom who helps Bill in the operation and Stacy who lives and works off the farm. Bill may set up one business entity

for the farming operation with the intent of passing ownership of this entity to Tom. Bill may set up another business entity that controls the farmland he owns and then have this entity enter into long-term leases with the first entity. Bill may pass this second entity onto Stacy to allow her access to the income generated by the family farmland.

Use of a business entity is one way to gift shares in the entity to family members.

One final note on business entities, as will be discussed in the next section on gifting: use of a business entity allows the parents to gift part of the farm assets and business to their heirs through shares in the entity. This allows parents to retain control over the operation, reduce their future estate tax burden, and take full advantage of the yearly gift tax exemption.

Gifting

Currently, an individual can give up to \$14,000 a year to one individual without incurring the federal gift tax. Once you give a gift though, you cannot get it back – there can be “no strings attached” to a true gift. Any amount in gifts exceeding \$14,000 a year¹ to any particular individual is taxed by the federal government at a rate of 40%.² However, people can use part of their Unified Credit to cover the taxes due. The Unified Credit is a tax credit given to every U.S. citizen and resident to use against wealth transfer taxes, either taxable gifts or estate bequests. In 2013, the Unified Credit is \$2,045,800 per person and exempts a total of \$5,250,000 in cumulative lifetime gift and estate transfers, and will be adjusted each year after 2013 based on inflation.³ If one uses this tax today to avoid taxation on their gifts, it decreases what will be available at the time of their death. For example, Jim gives \$24,000 per

¹ This \$14,000 limit is now indexed for inflation to the lowest \$1,000. Thus, it is likely you will be able to gift more than \$14,000 in future years.

² Some gifts can exceed \$14,000 without facing the gift and estate tax. These include gifts to a spouse, payment of another's tuition or medical expenses paid directly to the institution or physician, and donations to charity.

³ All gifts since 1976 that exceed the annual limit are subject to tax. A tax payer can use the Unified Credit to cover this tax even before death. But lifetime gifts available for the credit cannot exceed \$5.25 million in 2013, and this amount will be adjusted for inflation every year after 2013.

If a family knows that the farm will be transferred after the death of the owner, one way to reduce estate taxes and achieve other goals is to start the transfer before the owner's death.

year to each of his five children for ten years running. Because he is giving \$10,000 more than the tax exempt amount of \$14,000, each individual gift has a tax liability of \$10,000 per year. Thus in total, taxable gifts are \$50,000 for each year. Since Jim does this for 10 years, he incurs taxes on \$500,000 worth of gifts. By using his Unified Credit against this tax liability, Jim would only have enough Unified Credit remaining to cover \$4.75 million estate taxes when he passes, assuming the exempted amount does not increase due to inflation in the 10-year period. See more about making gifts as an estate planning strategy below. Before making a gift to a third party, you should verify the amount of annual exclusion allowed in any given year. For large estates, gifts can reduce the size of the estate and therefore the estate taxes. Gifts of farm property must always be valued at fair market value.

If a family knows that the farm will be transferred after the death of the owner, one way to reduce estate taxes and achieve other goals is to start the transfer before the owner's death. You can have the heir and possible new owner buy parts of the farm, land, livestock, or equipment. The ownership of these assets could be transferred with a parent- or current owner-financed mortgage to aid the new farmer. The family could transform the business into a limited liability company (LLC) under which each parent could give each child gifts of \$14,000/year of membership units in the LLC or partnership. The family could also set up a corporation⁴ with shares that can facilitate the transfer of ownership. Each parent can transfer at least \$14,000 worth of shares every year without reporting it on a gift tax return and without incurring any gift tax liability. This



number will increase each year based on inflation. In addition, the value of the membership units gifted can be reduced by discounting since the recipient does not control the property and cannot easily sell this minority interest in the family farm. A discount of between 20% and 40% of the value of the gift property may be justified.

For example, George and Abigail Lewis have one son, Henry who wishes to take over the farm. He begins by purchasing pieces of equipment from his parents. They decide that transferring the farm through shares may be the easiest procedure, so they set up a subchapter S corporation with one share for each acre in the farm. George and Abigail retain the bulk of the stock, holding onto their control over the farm. Both George and Abigail can gift Henry shares equal to \$14,000 (\$28,000 total) each calendar year without incurring any gift tax liability. If the 500-acre farm has a fair market value of \$3.5 million or \$7,000 an acre, then George and Abigail can gift Henry shares equal to the value of four acres each year without having to report the gift. The IRS recognizes that shares equal to four acres of the property have less than \$28,000 of value because Henry will have little control over decisions about the property and cannot sell his shares easily. Therefore, George and Abigail may actually give Henry more than four shares each year. As mentioned above, discounts between

⁴ Many types of corporations exist and using this format will have income tax implications. Also you want to maintain estate tax benefits such as special use exclusions. Please consult a tax attorney or accountant to determine if this is a good strategy for your situation.



PHOTO: EDWIN REMSBERG

20% and 40% of the value can be taken. Henry may be able to receive shares with underlying property valued at \$30,000 to \$40,000 each calendar year without any gift taxes incurred by his parents. This strategy will require an appraisal of the value of the shares in the business. Even with these higher values, it will take the parents many years (90 to 120 years) to pass on a \$3.5 million farm in this fashion assuming it does not continue to increase in value. This timing indicates the importance of planning and beginning this process at the earliest date possible.

Making a will

Besides having conversations with your family, you need to draft a will. A will is a legal document that specifies what you want done with certain personal and real property when you die. Certain property cannot be included in the will based on how it is owned, such as life insurance policies and property held in joint tenancy, to be discussed in the next sections. A will needs to be signed and dated in front of two witnesses.

If you do not have a will, the state of Maryland will allocate the property in the following manner.⁵ The spouse will receive one half and any minor children of the decedent will share the remaining one-half. If all children are adults, the spouse receives \$15,000 plus one-half of the remaining estate and the adult children divide the balance. If an adult child has already died, his or her share of the estate goes to the deceased adult child's children (grandchildren). If only children remain alive, the estate is divided equally between them. If the decedent's parents are living and no children have been born, the spouse receives one-half of the estate plus \$15,000 with the parents receiving the balance of the estate. If the couple has no children and the decedent's parents are not living, then the spouse receives the entire estate. Others, such as brothers and sisters, grandparents, great-grandparents and stepchildren, will become eligible to

A will is a legal document that specifies what you want done with certain personal and real property when you die.

inherit if spouse, children, and/or parents are not alive. If a person has no living heirs, the estate will go to the local Board of Education.

This arrangement may be fine if no disagreements between parents and siblings arise. However, if one sibling has been working on the farm and wants to continue while the other siblings want their "share" now, this may force a land sale. Equal treatment under the law can result in a forced farm sale. Without writing a will, the decedent has no say over the disposition of the estate and this can cause disagreements, which may result in an outcome that no one would have wanted.

For example, if Marge and Bill die at the same time without leaving a will, their three children, Jane, Tom, and Mark, will inherit the property equally. If both Jane and Tom want to farm the property but cannot agree on a partnership, they

5 This process is known as "intestacy." Intestacy is simply defined as dying without a valid will. All states have a process for intestacy distribution of a deceased property and this process will vary from state to state.



PHOTO: EDWIN REMSBERG



PHOTO: EDWIN REMSBERG

may end up splitting the land into parcels. In addition, they must be able to purchase Mark's share in the land. A bank may not be willing to lend Jane or Tom enough money to buy out Mark, and even if they get the loan, Jane and Tom will begin farming with a heavy debt load. Marge and Bill could have made a will leaving the land to Jane and Tom and other assets to Mark, or set up an alternative arrangement that is fair although not equal to all the children and that will help to ensure the continuity and cash flow situation of the farm.

How to hold title to the property

How property is titled will determine the ease with which each partner can transfer property. Many farmers own their property with their spouse in a joint tenancy. Assets with this form of title will pass automatically to the remaining living joint tenant, and only one-half the value of the property will be subject to federal estate taxes.⁶ Spouses each holding sole title to part of the assets or holding them as tenants in common and can transfer of part of the assets to heirs other than the spouse to allow the use of both Unified Credits. Therefore one

question for a professional estate tax attorney or accountant is what is the most beneficial manner of owning the property to pass on the business.

As an example, Judy and Keith, husband and wife, jointly own a 200-acre farm with rights of survivorship. The farm is worth \$6.5 million and they each own \$250,000 in other non-joint assets. If Judy dies in 2012 and Keith dies in 2013, the farm automatically passes to Keith even though Judy's will has established that assets be distributed to other heirs with no federal estate taxes owed. Judy's savings, \$250,000, can be distributed to her heirs but not the farm due to the joint tenancy with rights of survivorship, which supersedes the will. Judy's estate was valued at \$3.5 million (\$3.25 million + \$250,000), well under the \$5.12 million exemption. When Keith dies, his estate would be valued at \$6.75 million (\$6.5 million + \$250,000). Keith is allowed to exempt \$5.25 million from federal estate taxes, and would also be able to exempt another \$4.87 million from Judy's unused federal estate tax exemption. Keith's estate would also pay no federal estate taxes due to his own federal estate tax exemption and the portability of Judy's unused

exemptions. By properly titling property and utilizing all available exemptions Judy and Keith would be able to save their heirs from paying federal estate taxes. However, if Judy had planned to leave part of the farm assets to her sister, this will happen only if Keith includes this in his will. Similarly, if she wanted the income from the farm to support her aging mother, Keith would be responsible for ensuring this occurs.

A trust is simply where the owner of real or personal property, called a trustor, transfers his or her title to the trust. A trustee manages the property for the benefit of a third person called a beneficiary.

Trusts

Trusts are legal devices that are useful in estate planning. A trust is simply where the owner of real or personal property, called a trustor, transfers his or her title to the trust. A trustee manages the property for the benefit of a third person called a beneficiary. Kinds of trusts that are used in estate planning include testamentary trusts, irrevocable trusts, and living trusts. A testamentary trust is a trust created under the terms of a will. An irrevocable trust cannot be adjusted or dissolved during the trustor's lifetime. A living trust can be adjusted or dissolved during the

⁶ For married couples, only one-half of the property will be included in the gross estate of the first person to die. Only one-half the value of the property is taxed because the view is that spousal joint tenants jointly bought the property together and shared the property equally during their lives. For non-spousal joint tenants, the IRS will include the proportionate share of the value that the deceased joint tenant provided upon original purchase. For example, if Father and Son owned land in joint tenancy, but Father paid for 90%, then 90% of the fair market value on the date of death is included in Father's estate.

trustor's lifetime. Farmers might set up an irrevocable trust to make lifetime gifts. Once the assets are placed in the irrevocable trust, the gift has occurred. Any appreciation of the farmland will then not be included as part of the estate upon death. However, by giving such a large gift you may have gift tax consequences. If these trusts occur within certain time periods prior to the death, they may be included in the estate as "gifts in contemplation of death." People can use an irrevocable trust for their life insurance policy. This is mentioned in the section below.

A will determines how the property is dispersed after death, but it does not avoid the probate procedure. When you die, someone must file the will with the registrar of wills and a probate estate is opened. In this sometimes lengthy process, the court ensures that all debts are paid from the proceeds of the estate and then approves distribution of the remaining property to the beneficiaries delineated in the will. As a public process, all information becomes publicly available. If you create a living trust, you can avoid the probate procedure for those assets titled in the trust.

You set up a trust over which you are the trustee. You place all or part of your property into ownership of the trust. As the trustee, you continue to have ownership rights over the trust and can manage the property as you wish but must designate a successor trustee to follow you. You continue to be the beneficiary of the income stream from the property in the trust. These trusts can also be revoked. The trust can be drafted so that the successor trustee has the right to take over when the original trustee suffers from dementia or other debilitating conditions. This may help as one ages and is not capable of managing one's personal

affairs. The trade-offs associated with a trust versus probate are the cost of setting up and maintaining the trust compared to public disclosure under probate court, probate costs, and possibly the amount of time taken to settle the estate.

Use of a trust does not reduce the size of the taxable estate nor does it reduce the estate tax burden. For example, if Bob and Mary have one child who will inherit the farm upon their deaths, Bob and Mary may consider using a living trust or two living trusts to effectively transfer their property to their child upon their deaths. Their child will be able to continue to operate the business and receive control and/or ownership of the assets immediately. Information about their estate will not be publicly available either.

There are many other types of trusts that may work for your particular situation that can be investigated with your attorney and/or professional adviser. A few include charitable remainder trusts, grantor retained annuity trusts, grantor retained unitrusts, qualified personal residence trusts, qualified terminable interest property trusts (to equalize the estates of each spouse), and supplemental/special need trusts.

Life Insurance

In circumstances when the family is land rich and cash poor, life insurance can provide the cash needed to pay the estate taxes. Even if part of the farm is to be sold, the cash provided by a life insurance policy permits the family to wait for the best buyer rather than sell



PHOTO: EDWIN REMSBERG



on short notice. Life insurance can be used to pay for expenses surrounding a death such as debts, taxes, and funeral costs. In addition, a family can employ the life insurance proceeds to provide the non-farm siblings with their share of the estate without selling the farm. However, life insurance can

be expensive depending on your life expectancy.

Although you do not have to pay income tax on life insurance proceeds, the money is included as part of your estate when calculating the gross estate unless you are not the policy owner. For example, you could give your daughter the money to purchase the policy on your life. (Of course, giving one's daughter money to pay the premiums would be considered a gift and must be less than the annual gift tax exclusion or a gift must be reported). You could instead choose to form an irrevocable life insurance trust on your own life. A trustee is named to pay the premiums and distribute the proceeds. Under such a trust, the insured can have no powers of ownership to avoid the life insurance pay-out being included in the estate value calculation. In addition, you cannot revoke the trust once formed; all decision-making is done by the trustee. The trust is technically the beneficiary of the policy but the children would be the beneficiaries of the trust. A trust may be drafted to pay the beneficiary, who can be the spouse and/or the children, interest on the proceeds, then at the spouse's death pass the principal to the children and other heirs in order to pay any estate taxes which are due.

Special Use Valuation under IRC 2032A

Farmers have an estate tax advantage in Internal Revenue Code Section 2032A: Special Use Valuation. Under the terms of this section, families who plan to continue farming for at least 10 years can have the farmland valued at its agricultural use value for estate tax purposes, which is often lower than its full market value. Section 2032A allows farmers to reduce the fair market value of their land by up to \$1,070,000 from their gross estate in 2013. This amount is indexed to inflation so it will be adjusted each year by the IRS. If the property is jointly owned by a couple, each of them can take the additional deduction permitting up to an additional \$2.08 million to be exempted from estate tax liability. The farm must be passed on to a family member, known as a qualified heir.

A qualified heir is defined as the deceased's:

1. Spouse;
2. Parents, grandparents, or great-grandparents;
3. A lineal descendant such as a child or grandchild;
4. A lineal descendant of the spouse, could be step-child or step-grandchild of the deceased;
5. A lineal descendant of the deceased's parents, could include the deceased's nephews or nieces or his own siblings;
6. A spouse, widow, or widower of anyone in 2, 3, 4, or 5; or
7. Legally adopted child of the deceased.

The qualified heir must be a blood relative of the deceased, the deceased's spouse, or the spouse of a blood relative. For example, Harry and Mary are married and have no children. Steven, a farmhand hired by Harry who is unrelated to Harry or to Mary, has taken an interest in running the agricultural operation. Mary dies in 2012 and Steven continues to help Harry run the farm. Harry passes away in 2013, leaving the farming operation to Steven. Harry's estate would not be able to claim special use valuation to value the farm, since Steven is not a qualified heir. This would be a situation where Harry and Mary would have wanted to sit down with a lawyer and discuss the most efficient way to pass on the farming operation to Steven.

If the qualified heir stops farming the property within 10 years, a recapture provision requires that the qualified heir pay the estate tax on the full market value plus interest. One special note here: the qualified heir must materially participate in the farming of the property, unless they are the surviving spouse, retired or disabled. Material participation means that the qualified heir takes some financial risk in the farming operation and participates in the management decisions. The qualified heir will not be able to just cash rent the property out to another person to continue the farming operation. Courts have continually found this to be a cessation in the farming operation by the qualified heir, and the qualified heir has been subject to the recapture provision. The IRS is more likely to allow the renting of the property to a family farm corporation or LLC that the qualified heir fully participates in. Crop-share arrangements

have been considered material participation but professional advice on specific arrangements would be worth obtaining if presented with this situation.

To be eligible, the family must elect to take the valuation within nine months of the landowner's death. In addition, at least half of the estate must consist of real or personal property which on the decedent's date of death was being used for a qualified purpose, such as farming by the decedent or a family member. At least 50% of the estate must be farm assets (land, buildings, animals or equipment). In addition, at least one quarter of the estate must consist of real property, such as farmland or other type of farm real estate, which passed from decedent to a qualified heir. This real property must have been owned and actively worked for a qualified purpose by the decedent or a family member for five of the eight years prior to the owner's death. If the farm is sold or not farmed by a family member in the 10 years after the death, the family will owe estate tax plus interest based on the market value of the property at the time of death.

In certain cases, families have chosen to use this valuation only on part of the estate. This allows some property, such as buildings and livestock, to be sold without invoking the recapture provision.

Aside from the ten-year recapture provision, the biggest drawback of using this special use valuation election is that the heir is not able to receive a step-up in the basis of the farm property, to the extent that special use valuation reduced the value of the property for valuation of the taxable estate. Often the original purchase price of the farm is much



PHOTO: EDWIN REIMSBERG

lower than its actual market value, resulting in significant capital gains taxes being owed if one sells some of the land or other assets. The family can increase the basis of the farm if the farm is inherited at the current market value of the estate. If the original purchase price of the farm was \$500 per acre and now the farm is worth \$4,200 per acre, the family can use the new value from the estate tax calculation as the basis, avoiding the capital gain tax on the difference in the sale price and purchase price of \$3,700 per acre. This stepped up basis is beneficial if the family is planning to sell the property. However, the maximum preferential income tax rate on capital gains is only 15% to 20% (depending on your income tax bracket) plus an additional 3.8% Medicare tax for income earners meeting certain requirements, while estate tax rates are 40% in 2013 and subsequent years. Thus, a family needs to consider which will benefit them the most. In many cases, utilizing the special use valuation can benefit a family much more than the lower valuation will hurt it. One would want to inherit part of the estate at the full value if possible (up to the exemption amount) and only place part of the estate under special use valuation.



PHOTO: KEITH WELLER, USDA

Under Section 2032A, the land is valued by the five-year average of the county cash rent for land of this soil quality minus the applicable property taxes, then divided by an interest rate (the federal land bank loan rate). In the case where a county cash rent amount cannot be found, the IRS may use the state agricultural assessment values or comparable sales of farmland. For example, cash rent on average for the past five years has been \$80 per acre, property taxes have been on average \$20 per acre for the past five years, and the average loan rate at the federal land bank is 4.25%. The special use valuation calculation would be as follows:

$$(\$80 - \$20) / .0425 = \$1,412 \text{ per acre in special land use value}$$

Special Use Valuation for Conservation Easement Property

IRC section 2031(c)(2) allows estates that contain real property subject to a conservation easement to reduce the valuation of the property for estate tax purposes by up to \$500,000. Any step up in basis is reduced by the amount that the valuation is reduced. For more information on using conservation easements as an estate planning tool, see Lynch, *Estate Planning and Conservation Easements*.

No more Family-Owned Business Exclusion

In previous years, there was a family-owned business deduction for estate-tax purposes. A family that planned to continue in the family business for an additional 10 years following the death of the owner and that met the requirements could claim this exemption. This exclusion has been eliminated from current estate tax provisions.

Deferred Dayment of 9 state Tax—Section 6166

If the farm business is 35% of the adjusted gross estate, you can defer the tax payments for 5 years. Then, the family can pay the tax liability in 10 annual installments. Basically, this extends the time period for paying the taxes to 15 years (compared to 9 months). This prevents having to sell property immediately to cover the tax liability. The amount of tax the family can defer is the percent of the total estate value that is the farm or the farm business. Thus, if the farm value was 75% of the total estate value, one can defer 75% of the taxes owed. The IRS also has set a lower interest rate on the tax owed of 2%. The non-farm portion of the estate will not be eligible for the lower interest rate.

Maryland Inheritance Taxes

Maryland has both an estate tax and an inheritance tax. The latter is paid first. Any inheritance tax paid will be deducted from the state estate tax liability.

Lineal Tax Rate

Maryland began to exempt property given to lineal heirs from the Maryland inheritance tax, as of July 1, 2000. Lineal heirs include parents and grandparents of the decedent, the spouse, the children, children's spouses, step-parents or step-children, siblings, grandchildren, and great grandchildren.

Collateral Tax Rate

A tax rate of 10% is applied to all property passed on to other people and organizations that were not identified as a lineal heir.

Exemptions From Tax

Life insurance policies payable on the death of the deceased but not owned by the deceased are exempted. The decedent can pass property to a charity tax-free (Section 501(c)(3) organization) if the charity is incorporated in Maryland or a reciprocal agreement

exists, or to state, county, or municipal corporations. If the net value of the estate is \$30,000 or less, the property is transferred without owing any state inheritance tax. Any one individual can receive \$1,000 without paying tax. In addition, no inheritance tax will be due on any income, gains, or losses during the probate period but income taxes will be due on that income. A grave maintenance fee of up to \$500 for the perpetual upkeep of graves is allowed to be exempted from the inheritance tax.

Maryland Estate Tax

Non-agricultural Properties

All families of deceased individuals who were a resident of Maryland at the time of death or who owned real or tangible personal property in Maryland must file a Maryland estate tax return. The return must be filed and the tax paid within 9 months of the death. For non-agricultural property, the estate tax rate is 16%. One million dollars is excluded from the value of the non-agricultural property for estate tax calculation. One can elect to pass on the non-agricultural property to one's spouse as "marital deduction qualified terminable interest" (tax-free) property even if the family chose not to identify it that way under federal estate tax computation. Due to the higher deduction on the federal estate tax, one might not choose to use the marital deduction to obtain the stepped up basis but use it with the state estate tax if the property is passed to the spouse and values more than \$1 million.

Maryland has decoupled its estate tax from the federal government's decreasing exclusion credit. To compute the Maryland estate tax, one needs to complete the federal estate tax return regardless of whether the family owes any federal estate tax. The tax owed to Maryland equals the maximum allowable credit for state estate tax from the federal return minus any inheritance tax owed. The maximum Maryland estate tax due will be no more than 16% of the estate value (gross estate minus any deductions minus \$1,000,000 minus any inheritance tax paid.)

Agricultural Property

In 2012, the Maryland legislature provided a special agricultural property estate tax exemption on the value of agricultural property for anyone predeceasing on or after January 1, 2012.⁷ This agricultural property estate tax exemption allows a deceased individual's estate to exempt the first \$5 million of agricultural property value from the calculation of a deceased individual's estate value. Any agricultural property value over \$5 million will be included in calculating your estate value and taxes due. The law is designed to help keep current agricultural property in agricultural uses and prevent the loss of agricultural properties to other uses. All non-agricultural property in the deceased individual's estate will still be subject to the \$1 million

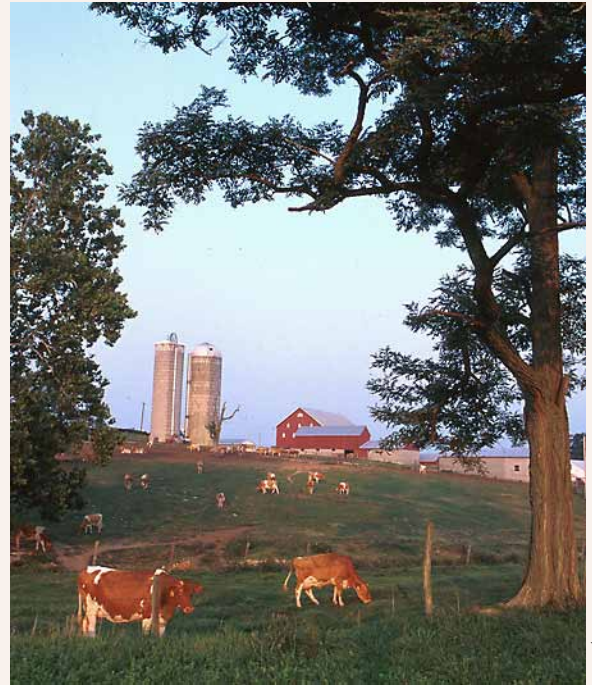


PHOTO: SCOTT BAUER, USDA

Maryland estate tax exemption previously discussed.

In order to use the agricultural property estate tax exemption, the deceased individual's agricultural property will need to be 1) "qualified agricultural properties," 2) used for a "farming purpose" and 3) passed to a "qualified recipient." "Qualified agricultural properties" are defined by the law as all real or personal property chiefly used for farming purposes. This includes not only the land used for agricultural production but also the equipment used for agricultural production. For example, Bill owns farmland and agricultural equipment in Dorchester County and residential rental properties in College Park. The farm has equipment and farmland valued at \$4 million and the residential rental properties are valued at \$1,000,000. When Bill dies, only the farmland and agricultural equipment qualify for this agricultural estate tax exemption. The residential rental properties would not qualify for the agricultural estate tax exemption. In order to qualify, the agricultural properties must be used primarily for a "farming purpose."

Any agricultural real or personal property

⁷ See Family Farm Preservation Act of 2012, 2012 Md. Laws Ch. 449, Md. Code, Tax-Gen. § 7-309, http://mlis.state.md.us/2012rs/chapters_noln/Ch_449_hb0444T.pdf.



PHOTO: EDWIN REMSBERG

“Qualified agricultural properties” are defined in the law to be all real or personal property chiefly used for farming purposes. This includes not only the land used for agricultural production but also the equipment used for agricultural production.

A “farming purpose” is broadly defined in 26 U.S.C. § 2032A(e)(5) to include:

1. Cultivation, raising, and harvesting of crops;
2. Raising, shearing, feeding, caring for, training, and management of animals;
3. Handling, drying, packing, grading, or storing on a farm any agricultural or horticultural commodity in its unmanufactured state, but only if the owner, tenant, or operator of the farm regularly produces more than one-half of the commodity so treated; or
4. Planting, cultivating, and caring of timber and the preparing (other than milling) of trees for market.

used for a farming purpose would be eligible for this agricultural property exemption. For example, Bill’s farm produces a mixture of vegetables, soybeans, and broilers. The equipment on the farm is used to aid in the production of these three commodities. The farmland and equipment would be used primarily for an agricultural purpose and would be qualified agricultural properties.

The deceased individual’s qualified agricultural property will need to be passed on to a “qualified individual.” A “qualified individual” is simply any person or persons willing to enter into a ten-year written agreement to use the qualified agricultural property for a farming purpose similar to the special value provision. However, unlike the special value provision, there is no requirement that a qualified individual be a family member of the deceased individual. A qualified individual could be any individual (family member, friend, business partner, etc) that the deceased individual wants to inherit the farm. Bill has no children

and no living relatives. Bill does have an employee, Rob, who has faithfully worked for Bill during the past 10 years and has been running the farming operation for the past three years. Under Maryland’s new agricultural estate tax exemption, Rob could be a qualified individual even though he is not related to Bill.

The qualified individual or individuals must enter into a written agreement with the State of Maryland that the exempted agricultural property will remain in agriculture for the next 10 years. The written agreement must include the following items:

- Consent to personal liability for the estate taxes exempted on the qualified agricultural property. This is required in case the qualified agricultural property ceases to be used for agriculture during the 10-year period.
- With multiple parties of interest in the qualified agricultural property, an agent must be appointed for all dealings with the Maryland Comptroller’s office. This agent

will provide any information requested by the Comptroller and notify the Comptroller when the property ceases to be used for an agricultural purpose.

The agreement will need to be signed by all qualified individuals inheriting an interest in the qualified agricultural properties. Also, any person holding an interest in the qualified agricultural property will need to sign the written agreement. For example, Bob and Tom, two brothers, held a tract of farmland joint without rights of survivorship and Bob dies, leaving his interest in the tract to his son Charlie. In order to qualify for the new agricultural property estate tax exemption, Tom would need to be a party to Charlie's written agreement with the State of Maryland.

Along with the written agreement, the deceased estate will need to attach certain documentation with the written agreement. Currently, the estate will need to attach an estate tax return with the following included:

- relevant qualified agricultural use;
- items of real property on the estate tax return that the estate tax reduction is claimed on;
- fair market value of the qualified agricultural property;
- proportion of the qualified agricultural property's fair market value for which a tax reduction is claimed;
- items of personal property on the estate tax return for which the estate tax reduction is claimed;
- adjusted value of the gross estate;
- copies of written proposals of the fair market value of the

real property;

- the amount of deductions claimed for Maryland estate tax purposes with respect to each item for which a tax reduction is claimed;
- amount of Maryland inheritance tax paid or to be paid with respect to each item for which a tax reduction is claimed;
- the name, address, taxpayer I.D. number, and relationship to the deceased of each person taking an interest in each item of qualified agricultural property and the value of that qualified agricultural property passing to each person;
- detailed calculations of the amounts of tax reduction claimed; and
- legal description of the qualified agricultural property.

During the 10 year period that the property must be used for agricultural purposes, the state of Maryland will hold a lien against the property in the amount of the estate taxes reduced because of this agricultural property exemption.

The new agricultural property tax exemption does allow more options to whom the family farm can be passed on than the special use valuation in the Internal Revenue Code allows. Special use valuation only allows for the farm property to be passed on to the deceased individual's surviving spouse, children, or parents in order to gain lower valuation of the agricultural property. With Maryland's agricultural property estate tax exemption, the deceased individual could pass the farmland and equipment on to any person. Looking at our example from the Special Use Valuation section, Rob would not qualify for



PHOTO: EDWIN REMSBERG

Special Use Valuation and Maryland's new agricultural estate tax exemption are two tools which can be utilized to limit estate taxes and allow a new generation of producers to continue successful, established operations.

the use of special use valuation because he is unrelated to Bill. Maryland's new special estate tax exemption is more forgiving when an agricultural producer tries to pass an agricultural operation onto non-family members. But a producer would need to consider leaving the operation to a qualified heir under Section 2032A in order to qualify for both the special use valuation and Maryland's agricultural property tax exemption.

One limitation to this agricultural property tax exemption is that the qualified agricultural property must continue to be used for an agricultural purpose for the next ten years after the deceased individual's death. The language of the statute appears to allow the qualified recipient to transfer the qualified agricultural property to a corporation, LLC, or trust as long as the qualified agricultural property continues to be used for a farming purpose. For example, Rob has inherited

Unlike in previous years, federal estate tax exemptions and tax rates are now permanent and will only change if Congress decides to change them in the future. But even though federal estate tax exemptions and rates are permanent, this does not mean the estate planning process is a one-time event.

Bill's farmland and equipment under this agricultural property estate tax provision. Rob decides to limit his own liability by creating an LLC to run the agricultural operation. Rob could create the LLC and either sell/gift/transfer the title of the land and equipment to the LLC or rent the land and equipment to the LLC without fear of recapture of exempted estate taxes.

If the qualified individual stops using the property for a farming purpose, then the state is able to recapture the Maryland estate taxes on the exempted \$5 million. For example, after Bill dies, Rob inherits Bill's farmland and agricultural equipment and signs the agreement stating he will continue to use the farmland and agricultural equipment for 10 years. In year 8, Bill's farmland is in a prime spot for a new strip mall and the developers are offering a lot of money for Rob to sell the land. If Rob did, he would be required to pay back all the exempted Maryland estate taxes on the farmland.

Southwick and Associates have estimated that in the Delmarva Peninsula farmers' farm and buildings have an average value of \$1.8 million. This new agricultural property estate tax exemption will allow many Maryland agricultural producers to pass their operations on to the next generation

avoiding costly Maryland estate taxes.

Ongoing

Unlike in previous years, federal estate tax exemptions and tax rates are now permanent and will only change if Congress decides to change them in the future, i.e. there are no sunset dates included. But even though federal estate tax exemptions and rates are permanent, this does not mean the estate planning process is a one-time event. The actual estate plan needs to be revisited from time to time (every three to five years) to ensure it continues to satisfy your needs and fulfill the goals you have set. In some cases, the farm will be passed on when the owner retires and therefore disposition at death is not a necessary component of the estate plan; in others the birth of a new child or grandchild might require an alteration. In addition, new tools can appear to facilitate the transfer of farmland with a minimum of tax impact such as Maryland's new agricultural property estate tax exemption. Also, thinking about certain options ahead of time can facilitate decision-making in a stressful and grief-ridden time, especially if such a decision as using the special use valuation provision must be made in a short period of time. ■

Reference:

Amihere, Dana. *When Farm Owner Dies, New Estate Law Should Help Families Keep It In Business*, MARYLAND REPORTER, June 1, 2012, <http://marylandreporter.com/2012/06/01/when-farm-owner-dies-new-estate-law-should-help-families-keep-it-in-business/>.

Cosgrove Jeremiah P. and Julia Freedgood, *Your Land is Your Legacy: A Guide to Planning for the Future of Your Farm*, American Farmland Trust, Washington, D.C., 1997.

Family Farm Preservation Act of 2012, 2012 MD. LAWS Ch. 449, MD. CODE, TAX-GEN. § 7-309, http://mlis.state.md.us/2012rs/chapters_noln/Ch_449_hb0444T.pdf.

Internal Revenue Service, Highlights of 2008 Tax Changes, Publication 553, June 2009.

Internal Revenue Service, Introduction to Estate and Gift Taxes, Publication 950, Rev. Oct. 2011.

Internal Revenue Service, “Instructions for Form 706: United States Estate (and Generation-Skipping Transfer) Tax Return,” August 2011.

Johnson, Dale M., Lessley, Billy V., and James C. Hanson, Assessing and Improving Farm Solvency, Maryland Cooperative Extension Fact Sheet No. 540, 1989.

Register of Wills Association, Administration of Estates in Maryland, Sept. 2009.

Rumley, Rusty W., “An Overview of Special Use Valuation Under 26 U.S.C.A. § 2032A,” National Agricultural Law Center, Jan. 2011.

Sciabarrasi, Michael, “Introduction to Estate Planning,” Estate Planning Workshop, Easton, Maryland, August 24, 2004 and Mt. Airy, Maryland, August 25, 2004.

Tengel, Patricia M., Estate Planning: Owning and Transferring Property, Maryland Cooperative Extension Fact Sheet 410.

Tengel, Patricia M., Estate Planning: Writing Wills in Maryland, Maryland Cooperative Extension Fact Sheet 382.

Tengel, Patricia M., Estate Planning: Goals, Net Worth, and Final Instructions, Maryland Cooperative Extension Fact Sheet 414.

Note: This publication is intended to provide general information about legal issues and should not be construed as providing legal advice. It should not be cited or relied upon as legal authority. State and federal laws vary and no attempt is made to discuss laws of states other than Maryland. For advice about how these issues might apply to your individual situation, consult an attorney.



Lori Lynch



L. Paul Goeringer

Estate Planning for Farm Families

Authored by:

Lori Lynch, Professor
Extension Economist

Paul Goeringer
Extension Economist/Lawyer

Wesley Musser
Extension Economist

This publication is offered in a partnership with:

AGRICULTURAL LAW EDUCATION PROJECT



SCHOOL of AGRICULTURAL AND NATURAL SCIENCES



University of Maryland
Department of Agricultural
and Resource Economics

Symons Hall, Room 2119
College Park, MD 20742
<http://agresearch.umd.edu/CANRP/>
(301) 405-1293



In accordance with Federal law and U.S. Department of Agriculture policy, this institution is prohibited from discriminating on the basis of race, color, national origin, sex, age, or disability. To file a complaint of discrimination, contact USDA, Office of the Assistant Secretary of Civil Rights, Whitten Building, 1400 Independence Ave., SW., Washington, D.C., 20250-9410 or call [1-866-632-9992](tel:1-866-632-9992) Toll Free; or [1-800-877-8339](tel:1-800-877-8339) Federal Relay Service; or [1-800-845-6136](tel:1-800-845-6136) (In Spanish); or [1-800-795-3272](tel:1-800-795-3272) between the hours of 8:30 am and 5:00 pm Eastern Standard Time; or (TDD) 720-2600. USDA is an equal opportunity provider and employer.